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In The

Supreme Court of the United States

LEHMAN BROTHERS BANK, FSB,

Petitioner,

v.

STATE BANK COMMISSIONER,

Respondent.

On Petition For A Writ Of Certiorari To The Supreme Court Of Delaware

REPLY BRIEF

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STATEMENT OF THE CASE

This replies to Respondent's Brief in Opposition ("Br. in Opp."), wherein Respondent asks this Court to sanction the taxation by Delaware of 100% of the income of Lehman Brothers Bank, FSB ("Lehman" or "Bank"), notwithstanding that it operates a nationwide mortgage banking business. Lehman was denied the right to apportion its income even though nearly all of its income-generating activities took place outside Delaware. Taxing 100% of the Bank's income, and disregarding its activities in other states, violates both the Commerce and Due Process Clauses of the U.S. Constitution and is contrary to long-standing Supreme Court precedent.

This case presents a conflict between an obsolete tax statute and modern banking practices. The statute reflects an archaic regulatory regime that required banks to organize in specified forms, such as through branches and subsidiaries. Modern banking practices, however, have liberalized that regulatory regime and permit banks greater leeway in how they carry out their activities. Under Delaware law, only banks that conduct their multi-state activities through branches or subsidiaries can apportion their income, regardless of where that income is earned. Consequently, Lehman was denied the right to apportion notwithstanding that it earned nearly all of its income through out-of-state activities that were not conducted utilizing branches or subsidiaries. By taxing all of Lehman's income, the Delaware statute violates the Commerce Clause and Due Process

Clause requirement that a rational relationship must exist between the income taxed and the activities conducted within the state. Further, a state may tax only that part of a corporation's income that is fairly attributable to its income-producing activities in the state.

In urging this Court to deny certiorari, Respondent erroneously portrays Lehman as conducting its entire mortgage business in Delaware. Respondent's depiction of Lehman's activities is based not on the factual record, but merely on the designation of the Bank's "home office" in Wilmington, Delaware. The underpinning of Respondent's position is a federal banking regulation (12 C.F.R. § 545.91), which provides that a federal savings bank "shall be subject to direction from the home office." The "home office" designation, in turn, determines which of the twelve regional Federal Home Loan Bank ("FHLB") offices provides funding to the Bank. Br. in Opp. 9, 11. Although the designation of a "home office" has consequences for bank regulatory purposes, it has no relevance as to where Lehman earned its income, which is exactly what the Commerce Clause and Due Process Clause "fair apportionment" requirement is intended to measure.

Respondent states that the designation of Wilmington, Delaware as the location of Lehman's "home office" gave the Bank access to "the FHLB of Pittsburgh." Br. in Opp. 3, 11. But the Delaware "home office" designation is not what gave the Bank access to FHLB funding itself. Rather, the Bank's status as a

federally-chartered savings bank – and not the Bank's location or regulatory "home office" – allowed it access to funding from the FHLB system. Although the Bank obtained its funding from the Pittsburgh office of the FHLB (which covered Delaware, Pennsylvania and West Virginia), it would have been entitled to the very same funding, at the same rates, from any one of the other eleven FHLB offices had its "home office" been in another state.

Lehman furnished Respondent with a study prepared by PricewaterhouseCoopers LLP, an independent CPA firm, confirming that the Bank paid more than $106 million in state and local income taxes to other jurisdictions on the same income being taxed by Delaware. Respondent notes that the Delaware court found this proof inadequate. Br. in Opp. 6. As Lehman pointed out in its Petition, the State Bank Commissioner never questioned the Bank's undisputed proof of $106 million in taxes paid to other jurisdictions. Furthermore, an expert witness from PricewaterhouseCoopers who testified about those income taxes was never questioned by Respondent on this point. By taxing 100% of the Bank's income, Respondent has created multiple taxation. More fundamentally, it is the *risk* of multiple taxation, rather than proof of *actual* multiple taxation, that the "fair apportionment" mandate protects against. *See, e.g., Mobil Oil Corp. v. Commissioner of Taxes of Vt.*, 445 U.S. 425 (1980).

REASONS FOR GRANTING THE PETITION

I. THE DELAWARE COURT'S DECISION STANDS IN DIRECT CONFLICT WITH THE FAIR APPORTIONMENT MANDATE REQUIRED UNDER *COMPLETE AUTO*

Respondent claims that taxing 100% of Lehman's multi-state income satisfies the "fair apportionment" requirement of *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).[1] Br. in Opp. 7. Not surprisingly, neither Respondent nor the Delaware court has identified a single decision of this Court sanctioning that result. Although the Delaware Supreme Court held that the Bank was entitled to the protections of *Complete Auto*, the decision is actually a significant retreat from *Complete Auto*.

Respondent makes several references to the testimony of a Bank representative that the FHLB funding furnished to Lehman Bank "has to hit [the] books and records in the bank," Br. in Opp. 3, 11, suggesting that this should determine where the Bank's interest income was earned. While the precise meaning of "hitting the books" for accounting purposes is unclear, this Court has recognized that where income is sourced for accounting purposes is not determinative of where that income is earned. *See,*

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[1] Respondent's brief reveals that he believes a state constitutionally may deny apportionment to any Delaware domiciliary or to any federally-chartered bank. *See* Br. in Opp. 7 n.2 and 8 n.3.

e.g., Exxon Corp. v. Wisconsin Department of Revenue, 447 U.S. 207 (1980). Furthermore, Respondent has advanced a principle that would source income based on where money is borrowed from. The fundamental defect in Respondent's position is that sourcing income based on where money is borrowed ignores all other activities which generate that income. Respondent tries to defend his position denying apportionment by arguing that "but-for" the borrowed funds, Lehman would have no income. Br. in Opp. 11. However, the Bank's income was generated by a series of integrated and interdependent transactions, requiring not only a source of funds, but also the expertise of knowing how to use those funds. In order for the Bank to earn its income, appraisals had to be made of real estate, the creditworthiness of borrowers needed to be determined, documents needed to be prepared and processed, decisions had to be made about how much to invest and in what types of mortgages, and loans had to be secured by real property located outside Delaware. Any one of these necessary functions can be carved out and, if viewed in isolation, can be said in a "but-for" sense to be the key to generating the interest income. This "but-for" reasoning violates the Court's external consistency doctrine, which requires that an "apportionment formula must actually reflect a reasonable sense of how income is generated." *Container Corp. of Am. v. Franchise Tax Bd.,* 463 U.S. 159, 169 (1983).

Following the logic of the Delaware court's decision, any state where any one of these activities

occurs could be viewed as the source of the interest income. If every state with a connection to an activity that contributed to the generation of the mortgage interest were to adopt the court's reasoning, the Bank would be taxed on 100% of its income by numerous states. No state, including Delaware, should tax the Bank on all of its income when activities in numerous states were essential to the generation of the mortgage interest. To be sure, every state in which such activities take place is entitled to tax a fair share of such interest. But whatever Delaware's fair share is, it certainly is not 100%, especially in light of the fact that only 2% of the Bank's activities occurred in Delaware.[2]

Consider a Delaware shoe store that borrows money from a bank in Pennsylvania to finance its purchase of inventory in Maryland, which it sells at its store in Delaware. Under orthodox principles of state taxation, and the law in every state with an income tax, none of the income from the sale of the shoes would be sourced to Pennsylvania merely because the bank from which it borrowed money to finance its inventory was located there. In *Exxon Corp.*, 447 U.S. at 230, this Court rejected a multistate corporation's attempt to avoid apportionment on the grounds that its oil exploration and production

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[2] A study prepared by the CPA firm of Ernst & Young LLP, and verified by PricewaterhouseCoopers LLP, confirmed that on average only 2% of the Bank's activities occurred in Delaware. App. 220a.

activities took place entirely outside the state, with the Court noting the "geographic location of such raw materials does not alter the fact that such income . . . is subject to fair apportionment among all States to which there is a sufficient nexus with the interstate activities of the business." Although the Bank's FHLB funding may be important to its mortgage banking business, even if the funding was derived "through" Delaware (which the Bank disputes), it was only one component of how the Bank earned its income and does not justify the denial of *any* apportionment.

Respondent claims that the Delaware "branch/subsidiary apportionment system" satisfies the Commerce Clause because it is based on a bank regulatory system which limits where certain banking activities may be conducted. Br. in Opp. 9. Respondent is mistaken in several respects. First, beginning in 1990, the United States Office of Thrift Supervision ("OTS") permitted a federal thrift to carry on certain activities out of state, particularly mortgage banking related activities, without having to do so through a branch or subsidiary structure. 54 FR 50613 (Dec. 8, 1989). Since 1992, a federal thrift (such as Lehman) may, without notice to the OTS, engage in mortgage banking related activities, such as originating and servicing loans and managing and selling real estate owned by the thrift, through an agency office located in a state other than a state in which its "home office" or branches are located.

To the extent the Delaware law permits apportionment for income from out-of-state activities, it

recognizes only activities conducted through out-of-state branches and subsidiaries, notwithstanding the OTS' intent to the contrary to allow federal thrift activities at other types of offices. The Delaware law ignores not only the OTS' liberalized policies, but disregards the economic realities of the structure of the mortgage banking business. It directly conflicts with the modern banking practices allowing a mortgage banking business to be conducted in out-of-state agency offices or loan production offices. Similarly, Respondent's argument that banks should be treated differently for Due Process and Commerce Clause purposes is completely diminished by the realities of the modern day banking business.

In *Goldberg v. Sweet*, 488 U.S. 252, 254 (1989), this Court addressed a challenge to Illinois' sourcing of receipts from interstate telephone calls "against a backdrop of massive technological and legal changes in the telecommunications industry" following the deregulation of the industry. In rejecting the taxpayers' position against the sourcing of telephone call receipts based on customer billing addresses, this Court found it "significant that Illinois' method of taxation is a realistic legislative solution to the technology of the present-day telecommunications." *Id.* at 264. Here, Delaware's antiquated "branch/subsidiary apportionment system" is no longer practical for the modern banking industry, and taxing 100% of a bank's multi-state income violates external consistency.

While Respondent is correct that a state "enjoy[s] wide latitude" in fashioning a constitutionally acceptable method for apportioning income within and without a state, Br. in Opp. 9, such wide latitude does not authorize taxation of *all* income of a corporation that engages in substantial income-generating activities outside the taxing state.[3] Respondent cites this Court's decisions in *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267, 274 (1978) and *Oklahoma Tax Commission v. Jefferson Lines, Inc.*, 514 U.S. 175, 195 (1995). If anything, these decisions undermine Respondent's position that its "branch/subsidiary apportionment system" is constitutional. *Moorman* involved whether Iowa's single sales factor, rather than a three-factor apportionment formula, was constitutional, not whether Moorman was entitled to *any* apportionment. *Jefferson Lines* actually reaffirmed that an income tax must "be apportioned to reflect the location of the various interstate activities by

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[3] Respondent points to *Ford Motor Co. v. City of Seattle*, 156 P.3d 185, 190-92 (Wash. 2007), *cert. denied*, 128 S. Ct. 1224 (2008), as support for the argument that even if "some portion" of a company's activities take place outside the taxing state, it does not prohibit that state from taxing 100% of the Company's gross receipts. Br. in Opp. 16. The gross receipts tax in that case was imposed on Ford's gross receipts from sales made to dealers located *within the taxing jurisdiction*. *Id.* at 194. This is factually distinguishable from this case, which involves the taxation of 100% of the Bank's income earned throughout the United States.

which it was earned." 514 U.S. at 190.[4] Neither case sanctions the denial of apportionment under a state income tax to a multi-state business, particularly where other states had the right to and did tax a portion of the income of that business.

Finally, the Delaware statute violates *Kraft General Foods, Inc. v. Iowa Department of Revenue & Finance*, 505 U.S. 71 (1992), which held that unconstitutional discrimination is not cured merely because the taxpayer could have structured its business in a way as to avoid that discrimination. Respondent claims that *Kraft* is distinguishable, Br. in Opp. 17-18, but its claims ring hollow. First, Respondent argues that unlike the taxpayer in *Kraft*, Lehman does not claim that the Delaware tax is discriminatory. There is nothing in the language of that decision, and no basis in logic, to artificially limit *Kraft's* holding solely to violations of the "discrimination" prong of the four-part Commerce Clause requirements of *Complete Auto*. Respondent's other ground for disregarding *Kraft* – that the Bank's decision whether or not to establish a branch or subsidiary was not a choice as to the *form* of doing business but rather as to its *location* – is equally unsupportable.

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[4] Curiously, Respondent argues that this Court "has never so held" that the Commerce Clause "fair apportionment" requirement applies to a net income tax, Br. in Opp. 17, a claim that is contrary to such decisions as *Barclays Bank PLC v. Franchise Tax Board*, 512 U.S. 298 (1994) and *Amerada Hess Corp. v. Director, Division of Taxation*, 490 U.S. 66 (1988).

Respondent has denied apportionment to Lehman *precisely because* it did not conduct its activities in the form of a branch or subsidiary.

II. SUBSEQUENT AMENDMENTS TO THE DELAWARE BANK TAX LAW HAVE NO BEARING ON WHETHER THE DECISION BELOW SHOULD STAND

Respondent argues that the Delaware Supreme Court decision has "no practical effect going forward" because Delaware amended its bank tax law for tax years beginning after December 31, 2006. Br. in Opp. 20.

Respondent is incorrect for several reasons. First, the Delaware statute at issue remains part of the current law, and therefore remains an ongoing constitutional issue. Furthermore, although the amendment does provide an elective alternative tax calculation which allows apportionment of an income tax, that right to apportion income out of Delaware comes at a steep price: a minimum $2 million "relocation benefit tax" which is required to be paid *in addition* to the tax on income. Accordingly, that amendment suffers from similar constitutional problems as the provision at issue.[5] In addition, even if

[5] Among the constitutional defects of the 2006 amendments (which were enacted to encourage a major Delaware-based bank to retain its bank charter in Delaware) are that (i) it provides for an arbitrary $2 million minimum "location benefit tax," irrespective of the bank's level of in-state activity and (ii) the calculation

(Continued on following page)

the amendments did cure the constitutional defects of the statute prospectively, the Delaware Supreme Court decision remains in direct conflict with this Court's precedent under the Commerce and Due Process Clauses.

In the Motion to Dismiss the Writ of Certiorari as Improvidently Granted in *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996), the state also claimed that the Court should not accept certiorari because the issue "[was] of no continuing importance," 1995 WL 357491 at *3, because the tax at issue had subsequently been repealed. This Court refused to dismiss the writ of certiorari, noting that there remained a "justiciable controversy" despite the tax repeal "[b]ecause the repeal has no retroactive effect . . . it does not effect the tax years at issue in this litigation." *Fulton Corp.*, 516 U.S. at 328 n.1. Similarly, this Court should reject Respondent's argument that subsequent amendments to the Delaware bank tax, effective after the years in issue, have diminished the Delaware court decision's constitutional significance and the urgent need for this Court to step in.

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of the "location benefit tax," which is based on the bank's owned property, excludes from the tax base only those assets attributable to the operations of an out-of-state branch. Del. Code Ann. tit. 5, § 1101A(d). Furthermore, the 2006 amendments which offer this alternative tax calculation deny the right to utilize the alternative tax method to any taxpayer with an unpaid assessment (such as Lehman, by reason of its constitutional challenge to that assessment). 75 Del. Laws, c. 223, § 5 (2006).

CONCLUSION

Respondent has not shown that denying the right to apportion income to a multi-state business conducting nearly all of its activities outside Delaware satisfies the constitutional "fair apportionment" requirement under *Complete Auto*. Respondent's antiquated "branch/subsidiary apportionment system," which does not reflect present day banking practices, does not cure this constitutional infirmity. Moreover, Respondent cannot constitutionally source the income of a multi-state business based solely on where funds are borrowed while ignoring the substantial income-generating activities conducted in other states. The Delaware Supreme Court decision conflicts with the long-standing decisions of this Court, as well as with decisions from the highest courts of other states.

The Petition for a Writ of Certiorari should be granted.

Respectfully submitted,

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